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Introduction

Chairman Bayh and Ranking Member Martinez, thank you for the opportunity to participate in this important hearing on America's economic relationship with China and strategies regarding exchange rates and expanded market access.

I am here as President and chief operating officer of the Financial Services Forum, the chairing organization of the **ENGAGE CHINA** coalition – a partnership among eight financial services trade associations united in our support of the goals of the U.S.-China Strategic Economic Dialogue (SED).[1] By providing an overarching framework for the examination of long-term strategic issues, as well as coordination of ongoing bilateral policy discussions, the SED greatly enhances economic cooperation between the United States and China – to the betterment of the people of both nations.

The members of the Financial Services Forum and the **ENGAGE CHINA** coalition share Congress' commitment to maintaining a strong U.S. economy, enhancing savings, and opening world markets to American products and services. Among the array of policies necessary to achieve those goals is for the currencies of our major trading partners to be determined by the markets. At the same, we should not allow currency issues to overshadow our broader economic relationships with our trading partners. In the case of China, the issue of expanded market access – particularly with regard to financial services – is of far greater significance to the policy goals of maintaining strong U.S. economic growth and job creation.

The Importance of Market-Determined Exchange Rates

An exchange rate is just a price, the price of one currency in terms of another. As with any other commodity in a free market, the price of a currency should be determined by the interplay of supply and demand based on economic fundamentals. By reflecting investors' interest in holding assets denominated in one currency over assets denominated in another, market-determined currencies – just like standard prices in any economy – help direct scarce

[1] American Bankers Association, American Council of Life Insurers, American Insurance Association, The Council of Insurance Agents & Brokers, The Financial Services Forum, The Financial Services Roundtable, Investment Company Institute, and the Securities Industry and Financial Markets Association.

resources to their most productive uses. Market-determined currencies also have the benefit of serving as a correction mechanism for the global economy – as a falling currency helps stimulate demand for the products of a slumping economy, and a rising currency helps cool demand for the products of a booming economy.

As the members of this subcommittee know very well, one of our most important trading partners is China – currently the world's fourth largest economy and soon to become the third largest. Since China's accession to the World Trade Organization (WTO) in December of 2001, trade between the United States and China has nearly tripled, exports to China have grown at five times the pace of U.S. exports to the rest of the world, and China has risen from our 9th largest export market to our 4th largest.

Fair and competitive access to China's fast-growing middle class and business sector represents an unprecedented commercial opportunity for U.S. manufacturers, farmers, and services providers, with profound implications for U.S. economic growth and job creation. But to continue growing – and for the yuan to float freely according to market forces – China needs a more open, competitive, and effective financial system. The fastest way for China to develop the modern financial system it needs is to import it – that is, by opening its financial sector to greater participation by foreign financial services firms. I'll have more to say about this in a few moments.

China and the Yuan

In recent years the discussion in Washington regarding the U.S.-China economic relationship has focused in large part on China's currency policy. Many policymakers assert that an undervalued yuan makes cheap Chinese exports even cheaper, giving Chinese producers an unfair advantage over American companies and contributing to the U.S. trade deficit with China.

A market-determined yuan is important – for the United States and especially for China. Foreign exchange market intervention by the People's Bank of China – buying dollars with yuan – has boosted liquidity in China's economy, thwarting government efforts to scale back excessive bank lending and fixed investment. Speculative money flowing into China in anticipation of a revaluation is also undermining government objectives. Finally, allowing the yuan to more fully float according to market forces would free the PBOC to pursue monetary policies that advance China's macroeconomic goals. For these reasons – as well as the priority of a more fair and transparent trade relationship – U.S. policymakers should continue to press China to accelerate progress toward a market-determined yuan.

For years, the United States has worked with China toward achieving a yuan whose value is determined by market forces. Indeed, shortly after taking office, the Bush Administration committed to helping China develop the capital markets know-how and expertise necessary to end the yuan's peg to the dollar, providing massive technical assistance. And those efforts have begun to bear fruit. In July of 2005, China revalued its currency upward by 2 percent. Since mid-2006, the pace of appreciation has accelerated, averaging about 4.9 percent a month at an annualized rate, and quickening to around 5.4 percent in the first few months of 2007, as China has become more confident about the resilience of its economy. In total, the yuan has appreciated by about 8 percent since July of 2005.

This is important progress – but, clearly, much more progress is needed. Given the importance of a market-determined yuan to the economic objectives of both countries, the United States should continue to press China to redouble its reform efforts and accelerate movement toward a freely floating yuan.

But even as we continue to press China on the yuan, we should not allow the currency issue to overshadow the broader potential of the U.S.-China economic relationship. Indeed, it should be noted that the short term effect of a significant appreciation in the yuan would likely be to make the trade deficit *worse*. Because a higher-valued yuan would mean higher prices for imported Chinese goods, and because the process of finding cheaper alternatives to more expensive Chinese goods takes time, the trade deficit would likely get worse before getting better – a phenomenon economists call the J-curve effect.

Of far greater significance to the policy goals of maintaining strong U.S. economic growth and job creation is for China to achieve a more sustainable model of continued economic growth and for its population of 1.3 billion – a fifth of the world's population – to begin consuming at higher levels. Both goals require reform and modernization of China's financial sector.

Critical Importance of Financial Sector Reform in China

Capital is the lifeblood of any economy's strength and well-being, enabling the investment, research, and risk-taking that fuels competition, innovation, productivity, and prosperity. The financial system can be thought of as an economy's cardiovascular system – the institutional and technological infrastructure for the mobilization and allocation of the economy's lifeblood, investment capital.

Given the unique and critical role an effective and efficient financial sector plays in any economy, reform of China's financial sector is a *prerequisite* to China achieving its own economic goals of: 1) maintaining high rates of growth and job creation; 2) encouraging a structural shift from industry to services; 3) promoting the development of domestic consumer demand; 4) reducing poverty; and, 5) ensuring a more equitable distribution of opportunity and prosperity.

Financial sector reform is also a prerequisite to meaningfully addressing issues that have complicated the U.S.-China economic relationship, particularly greater currency flexibility and reducing trade imbalances.

Achieving China's Economic Priorities

- *Maintaining High Rates of Growth and Job Creation*: Maintaining exceptional rates of economic growth and job creation in China increasingly depends on an effective system for mobilizing investment capital. At present, China's weak banking system intermediates nearly 75 percent of the economy's total capital, compared to about half in other emerging economies and less than 20 percent in developed economies. Despite some improvements in recent years, Chinese banks' credit analysis, loan pricing, risk management, internal controls, and corporate governance practices remain inadequate. Meanwhile, China's equity and bond markets are among the smallest and least developed in the world. More fully developed capital markets would provide healthy competition to Chinese banks and facilitate the development and growth of alternative retail savings products such as mutual funds, pensions, and life insurance products. And by broadening the range of funding alternatives for emerging companies, more developed capital markets would greatly enhance the flexibility and, therefore, the stability of the Chinese economy.

- *Shifting from a Manufacturing-for-Export to a Services-Based Economy*: Facilitating China's desired transition to a more services-based economy will require that competitively priced capital and credit be channeled to the most promising emerging service businesses, and that the array of financial products and services emerging businesses require – loans, letters of credit, accounts management services, asset management, and insurance products – be made available.

- *Activating the Chinese Consumer*: Chinese households historically save as much as a third of their income, as compared to single-digit savings rates in the United States and Europe. This pronounced propensity to save is related to the declining role of the state and the fact that most Chinese depend on their families and private savings to pay for retirement, healthcare, and the economic consequences of accidents or disasters. Activating the Chinese consumer requires the availability of financial products and services – personal loans, credit cards, mortgages, pensions, insurance products, and insurance intermediary services – that will eliminate the need for such "precautionary savings" and facilitate consumption.

Meaningfully Addressing Issues with the United States

A more effective and efficient financial sector in China is also a prerequisite to successfully addressing issues that have complicated the U.S.-China economic relationship, particularly further currency reform and meaningfully reducing the trade imbalance.

- *Market-determined exchange rate*: A Chinese authorities have repeatedly argued – reasoning generally acknowledged by most foreign analysts – that a more rapid shift to a market-determined yuan is not possible given the underdeveloped state of China's capital markets. More specifically, China's banks, securities firms, and other businesses lack the expertise to develop and trade derivatives and other structured instruments used to hedge the risk associated with greater currency volatility. Sophisticated derivative products and hedging techniques provided by foreign financial services firms would clearly diminish such concerns.

- *Reduction of trade deficit*: Reorienting the financial habits of China's population from precautionary savings to a better balance between savings and consumption – while progressively bringing more than a billion Chinese into the global economy – is the most powerful remedy to the U.S.-China trade imbalance. Last year, the United States exported to Japan goods and services worth $60 billion – approximately the same amount exported to China ($55 billion). But China's population of 1.3 billion is ten times Japan's population of 127 million. If U.S. exports are expressed in relation to population, the U.S. sold the equivalent of $472 worth of goods and services to every citizen of Japan last year, but only about $40 worth of goods and services to every Chinese citizen. If China's citizens were to eventually consume American-made goods and services at the same rate that Japan's citizens did last year, the United States would export more than $600 billion worth of goods and services to China, 11 times what America exported to China last year, an amount equivalent to 5 percent of America's GDP, and more than twice what we imported from China last year – replacing the trade deficit with a significant surplus.

Status of Financial Sector Reform in China

In addition to working to meet its WTO commitments, China has also taken important steps to liberalize its financial sector and improve financial regulation. For example:

- The financial sector has been transformed from a single-bank system to a more diversified system with a central bank at the helm.
- Meaningful steps have been taken to eliminate state-directed policy lending, and amendments to the Law on Commercial Banks and the Law on the Peoples Bank of China have laid the foundations for commercially viable lending.
- The China Banking Regulatory Commission (CBRC) was established in April of 2003 to oversee all banks in China, investigate illegal banking operations, and punish violations of law.
- Interbank, equity, and foreign exchange markets have been established and important progress made toward implementing monetary policy through market mechanisms rather than by government fiat.

Despite these significant achievements, China's financial sector still faces serious challenges:

- Non-commercial lending to state-owned enterprises continues, although on a diminishing scale.
- The stock of nonperforming loans on banks' balance sheets remains high.
- Banks are undercapitalized and lending practices, risk management techniques, new product development, internal controls, and corporate governance practices remain inadequate.
- Prudential supervision and regulation of the financial sector is opaque, applied inconsistently, and lags behind international best practices.

- China’s equity and bond markets remain small and underdeveloped.

With these problems in mind, efforts to build on the progress achieved to date should focus on:

- The critical importance of open commercial banking, securities, insurance, pension, and asset management markets to promoting the consumption-led economic growth that China’s leaders seek;

- The clear benefits to China of increased market access for foreign financial services firms – namely the introduction of world-class expertise, technology, and best practices – and the importance of removing remaining obstacles to greater access.

  Foreign investors in Chinese banks remain limited to 20 percent ownership stakes, with total foreign investment limited to 25 percent. The China Securities Regulatory Commission (CSRC) continues to limit foreign ownership of Chinese securities firms to 33 percent and foreign ownership of Chinese asset management companies to 49 percent. Worse, since December of 2005 has imposed a de facto moratorium on foreign investments in Chinese securities firms. The moratorium is inconsistent with the letter, and certainly the spirit, of China’s WTO commitments. Foreign life insurance companies remain limited to 50 percent ownership in joint ventures and all foreign insurers are limited to 25 percent equity ownership of existing domestic companies.

  While these caps were agreed to in the course of WTO accession negotiations, the limitations are among the most restrictive of any large emerging market nation and stand in the way of a level playing field for financial service providers. Most importantly, they limit access to the products, services, know-how, and expertise that China needs to sustain high rates of economic growth, and that China’s businesses and citizens need to save, invest, and create and protect wealth. For these reasons, the United States and other WTO members have urged China to relax these limitations.

  China also continues to restrict access by foreign credit card companies. Banks in China are permitted to issue a credit card with a foreign logo only if the card is co-branded with the logo of China Union Pay (CUP), an entity created by the People’s Bank of China (PBOC) and owned by participating Chinese banks. In addition, all yuan-denominated transactions must be processed through CUP’s network, while the network of the foreign credit card company is used only to process foreign currency transactions.

- Non-discriminatory treatment with regard to licensing, corporate form, and permitted products and services.

- Non-discriminatory treatment with regard to regulation and supervision.

- Regulatory and procedural transparency.

- Attracting sophisticated institutional investors to China's capital markets through the expansion of the Qualified Foreign Institutional Investor (QFII) and Qualified Domestic Institutional Investor (QDII) programs.

- Priority issues from the Transitional Review Mechanism that remain unresolved.[2]

Conclusion

Mr. Chairman, the fastest way for China to develop the modern financial system it needs to achieve more sustainable economic growth, allow for a more flexible currency, and increase consumer consumption is to import it – that is, by opening its financial sector to greater participation by foreign financial services firms. Foreign institutions bring world-class expertise and best practices with regard to products and services, technology, credit analysis, risk management, internal controls, and corporate governance. In addition, the forces of competition brought by foreign institutions would accelerate the development of modern financial techniques and methodologies by China's financial institutions.

By providing the financial products and services that China's citizens and businesses need to save, invest, insure against risk, raise standards of living, and consume at higher levels, foreign financial institutions – including U.S. providers – would help create what every U.S. manufacturer and service provider wants – an unleashed Asian tiger hungry for U.S. products.

Thank you very much for the opportunity to appear at this important hearing.

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[2] China's WTO accession included the Transitional Review Mechanism (TRM) as a means for ongoing review of China's compliance with its obligations, and to provide those elements of the Chinese government supportive of further economic reform with information and evidence to urge full compliance with China's WTO commitments.